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Technical Coordination Report TCR 17,907 -- TR-45-1156-91

Dated: June 24, 1991
Submitted by: Bruce Gerken
District: Parkersburg
Recommending: Amendment or clarification of section 7872

In the above identified TCR, Mr. Gerken presents a fact pattern in which the Taxpayer, a cash basis corporation, receives various demand loans from its shareholder, also on the cash basis. The loans bear interest at or above the applicable Federal rate (AFR), but such interest is not actually paid until the loan is called by the shareholder. The loans are not below-market since interest is payable on the loans at rates at or above the AFR. Mr. Gerken cites the following problems with this scenario and recommends that section 7872 of the Code be clarified or amended to address these problems:

- (1) Under section 7872, taxpayers who actually pay interest below the AFR appear to be worse off than taxpayers who merely promise to pay interest at or above the AFR.
- (2) Cash basis taxpayers are less likely to be scrutinized under section 7872 since they are subject to less vigorous bookkeeping and disclosure rules than are accrual basis taxpayers.
- (3) Taxpayers may produce notes that accrue interest at or above the AFR and avoid section 7872.
- (4) Interest accrued at or above the AFR may ultimately never be paid, raising

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a host of administrative and statutory problems in applying section 7872.

Section 7872 of the Code recharacterizes a below-market loan (a loan made in which the interest rate charged is less than the applicable Federal rate) as two transactions. First, there is an arm's length transaction in which the lender makes a loan to the borrower in exchange for a note requiring the payment of interest at the applicable Federal rate; second, there is a transfer of funds by the lender to the borrower ("the imputed transfer"). The timing and characterization of the imputed transfer by the lender to the borrower are determined in accordance with the substance of the transaction.

Section 7872(a) of the Code provides that in the case of a below-market gift loan or demand loan, the foregone interest shall generally be treated as transferred from the lender to the borrower and retransferred from the borrower to the lender as interest at the end of each calendar year. "Foregone interest" is defined by section 7872(e)(2) as the excess of the amount of interest which would have been payable at the end of the calendar year had the interest accrued at the applicable Federal rate, over the interest payable on the loan properly allocable to such period.

Section 1272(a)(1) provides that there shall be included in the gross income of the holder of any debt instrument having original issue discount (OID) issued after July 1, 1982, an amount equal to the sum of the daily portions of the OID for each day during the taxable year on which such holder held such debt instrument.

Section 1273(a)(1) provides that the term "OID" means the excess (if any) of the stated redemption price at maturity over the issue price. Section 1273(a)(2) provides that the term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes interest and other amounts payable at that time (other than interest based on a fixed rate, and payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the debt instrument).

Section 1272(a)(3) provides that for purposes of section 1272(a)(1), the daily portion of OID on any debt instrument shall be determined by allocating to each day in any accrual period its ratable portion of the increase during such accrual period in the adjusted issue price of the debt instrument. For

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purposes of the preceding sentence, the increase in the adjusted issue price for any accrual period shall be an amount equal to the excess (if any) of the product of the adjusted issue price of the debt instrument at the beginning of such accrual period, and the yield to maturity (determined on the basis of compounding at the close of each accrual period and properly adjusted for the length of the accrual period), over the sum of the amounts payable as interest on such debt instrument during such accrual period.

Section 1.1272-1(f)(3)(ii) of the Proposed Income Tax Regulations provides that the yield of a debt instrument that has an issue price equal to its stated principal amount, including a debt instrument that has an indefinite maturity (for example, a loan payable on demand), and that calls for a fixed rate of interest over the entire term of the debt instrument compounded at periodic intervals of one year or less, shall be the stated interest rate. For example, if A lends B \$100,000, repayable on demand or at a time that is not ascertainable on the issue date, with interest payable at 12%, compounded semiannually, all interest to be added to principal and payable at maturity, the yield of this loan is 12%, payable semiannually.

Section 1.1273-1(b)(ii)(A) of the proposed regulations provides that a qualified periodic interest payment is not included in determining the stated redemption price at maturity. The term "qualified periodic interest payment" means any one of a series of payments equal to the product of the outstanding principal balance of the debt instrument and a single fixed rate of interest, or a variable rate tied to a simple objective index of market interest rates governed by §1.1275-5, that is actually and unconditionally payable, or will be treated as constructively received under section 451 and the regulations thereunder, at fixed, periodic intervals of one year or less during the entire term of a debt instrument (including short periods).

Mr. Gerken states that under section 7872, taxpayers who actually pay interest below the AFR are worse off than taxpayers who merely promise to pay interest at or above the AFR. For the sake of this discussion, we assume that Mr. Gerken is comparing taxpayers that actually pay interest below the AFR and that do not accrue additional interest with taxpayers that accrue interest at or above the AFR and do not actually ever pay any interest. We are also assuming that the loan which accrues interest that is not ultimately paid is not recharacterized by the Service as a below-market loan (the

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problems inherent with such recharacterization are further discussed below). Under such circumstances, the holder of a debt instrument that accrues interest at a fixed rate of interest, where such interest is not payable until maturity, must include in income portions of such interest under the OID provisions. See section 1.1272-1(f)(3)(ii) of the proposed regulations. Therefore, in the above example, the cash basis shareholder must include the deferred interest in income currently. (We recognize that a cash basis taxpayer may be less likely to be scrutinized than an accrual basis taxpayer due to less restrictive accounting requirements. This problem pervades the Code and is not peculiar to section 7872).

Mr. Gerken correctly states that taxpayers that produce demand notes that accrue interest at or above the AFR can avoid section 7872, since the loans memorialized by such notes would not have "foregone interest" as defined by section 7872(e)(2) of the Code, and technically would not be below-market (taxpayers may also produce term notes that accrue, but defer, interest at the AFR and avoid section 7872). The legislative history of section 7872 reveals that the conferees recognized that a term loan with deferred interest at a rate equal to or greater than the AFR, and a related gift to defray all or part of the interest payable on the loan, may be the economic equivalent of an interest-free loan with a principal amount equal to the sum of the actual stated amount of the loan and the amount of the gift. The conferees anticipated that under regulations, such a transaction would be treated in accordance with its economic substance. H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1021 (1984) 1984-3 (Vol. 2) C.B. 275.

Section 1.7872-11 of the proposed regulations provides that under certain conditions, a loan requiring the payment of stated interest may be treated as a below-market loan when the accrued but unpaid interest is subsequently waived, cancelled, or forgiven by the lender. However, as noted by Mr. Gerken, when interest is not ultimately paid on loans that accrue interest at or above the AFR, it may not be administratively or statutorily feasible at that time to treat such loans as below-market loans under section 7872. We are aware of these administrative and statutory problems, and are currently working to resolve these problems in developing final regulations under section 7872.

We appreciate Mr. Gerken's interest and hope he will continue to submit his ideas. This memorandum is for general

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information purposes only and does not constitute technical advice on any matter.